

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department on its own motion into the appropriate regulatory plan to succeed price cap regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' retail intrastate telecommunications services in the Commonwealth DTE of Massachusetts 01-31

**COMMENTS OF AT&T COMMUNICATIONS OF NEW ENGLAND, INC.**

**REGARDING SCOPE OF PROCEEDING**

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**COMMENTS OF AT&T COMMUNICATIONS OF NEW ENGLAND, INC.**

**REGARDING SCOPE OF PROCEEDING**

Pursuant to the Hearing Officer's May 7, 2001 memorandum in this docket, AT&T Communications of New England, Inc. ("AT&T") files these comments proposing the proper scope of this proceeding.

**Introduction**

On February 27, 2001, the Department of Telecommunications and Energy ("Department" or "DTE") opened an investigation "to review the appropriate policy to succeed price cap regulation for Verizon's retail intrastate telecommunications services in Massachusetts." *Vote And Order To Open Investigation ("Order")* at 2. By law, the Department's policy must be designed to ensure that Verizon's retail rates are just and reasonable. *See*, Mass. G.L. c. 159, § 14 ("department shall determine the just and reasonable rates"), § 17 ("every unjust and unreasonable rate is hereby prohibited and declared unlawful"). The Department's undertaking in this docket, therefore, must consider a wide range of factors that determine whether Verizon's rates under the policy it adopts "to succeed price cap regulation" will be "just and reasonable."

In these comments, AT&T reviews the long history of the Department's efforts to regulate Verizon's retail prices in a manner that produces just and reasonable rates by encouraging competition. AT&T reviews the sound economic policy underlying the Department's pioneering orders, beginning with its 1985 groundbreaking decision in D.P.U. 1731, and identifies the critical and often difficult decisions that the Department has made in order to implement those orders. AT&T then identifies the outstanding issues that the Department has recognized remain to be solved and proposes that this proceeding complete the work that the Department began in D.P.U. 1731.

As explained in more detail below, the three critical elements of the Department's work in this docket should be the redesign of Verizon's rates to make them economically efficient and compatible with the development of local exchange competition, the implementation of an imputation based price floor to protect facilities based and UNEs based competition, and an explicit and competitively neutral universal service subsidy mechanism.

## **Comments**

### **I. THE SCOPE OF THIS PROCEEDING SHOULD REFLECT THE LONG HISTORY OF THE DEPARTMENT'S EFFORTS TO ESTABLISH VERIZON RETAIL PRICES THAT WILL PROMOTE COMPETITION.**

#### **A. Competition Is Preferable To Regulation For Achieving Efficient and Fair Prices, If The Market Is Fair And Open.**

In its landmark 1985 decision (D.P.U. 1731), the Department, based on an exhaustive analysis of the potential benefits of competition in post-divestiture intrastate telecommunications markets, articulated the public policy goals that were to guide its future regulation of the telecommunications industry in Massachusetts. The fundamental determination by the Department was that competition would be superior to regulation as a means to achieving the Department's rate goals of economic efficiency and fairness. The Department stated:

a competitive market will better promote our telecommunications goal of economic efficiency by requiring, in the long term, that prices be based upon marginal costs, and that incentives will be created to minimize those costs in order to maintain and expand market share. In addition, the evidence indicates that fairness may be furthered through competition, because a competitive marketplace will require that prices for services be driven toward their economic costs, thus helping to ensure that service classes are not paying more than the cost of providing service to that class.

D.P.U. 1731 at 25. The Department, however, has recognized that competition will work as a means of restraining Verizon's prices only if markets are sufficiently fair and open that competitors will come into the market. As discussed in the next section, therefore, one of the objectives in regulating Verizon's retail prices must be to prevent it from exercising its market power to foreclose competition.

#### **B. In Order To Ensure The Necessary Predicate Of Fair And Open Markets, Regulation Of The Prices Of The Dominant Provider Are Necessary Where The Dominant Provider Retains Significant Market Power.**

The Department explicitly recognized in D.P.U. 1731 that intraLATA telecommunications markets in Massachusetts were not then, and would not for the foreseeable future be, effectively competitive. *Id.* at 18. The Department discussed at length the regulatory principles that would guide its regulation of markets not effectively

competitive and its efforts to promote development of effective competition wherever feasible. The Department recognized the benefits of maintaining a high degree of control over the pricing of carriers with market power:

By maintaining a higher degree of regulatory control over those carriers that exhibit market power, we are better assured that economic efficiency and fairness will occur in the rates of all carriers.

*Id.* at 67. In recognizing the importance of constraining market power wherever competition is insufficiently developed. The Department stated:

One of the purposes of regulation is to ensure that suppliers in regulated markets do not raise prices to extract monopoly profits or engage in predatory pricing to eliminate competition . . . Under regulation, market power is not as great a concern to the Department, since regulation takes the place of marketplace forces and limits the ability of a carrier to engage in such predatory pricing and cross subsidization practices.

D.P.U. 1731 at 55-56.

The Department recognized that the elimination of legal barriers to competition in the intraLATA telecommunications markets would by no means result in an immediate, or even inevitable, reduction or elimination of the market power held by the traditional monopoly service provider. The Department explicitly considered the extent to which Verizon (then referred to by the now unfashionable name of New England Telephone, or "NET") would continue to have market power in the intraLATA markets for the foreseeable future. The Department noted, first, that Verizon "possesses an intraLATA monopoly for the local exchange network and that such a position is likely to continue in the foreseeable future." D.P.U. 1731 at p. 67. Given this finding, the Department went on to conclude:

Thus, NET has market power over the facilities currently used by ICs to originate and terminate interstate and intrastate, interLATA calls. An ability to control these necessary facilities is strong evidence of a need for a higher degree of regulation for NET's basic local exchange service.

*Id.* at p. 67.

The Department also established criteria for deciding when, and in what circumstances, it would be appropriate to reduce its traditional regulatory oversight of Verizon's services and pricing. The Department determined that: "The degree of regulation that should apply to a particular market should reflect the degree of competition present." *Id.* at 45. The rationale for tying any reduction in the degree of regulation of a traditional monopoly carrier to the degree to which competition has developed for that carrier's services was based on the Department's express recognition that "a danger exists if the Department moves to reduce the degree of regulation before sufficient competitive forces are present in a market." *Id.* at 55. The Department further stated:

As competition is introduced into a market . . . it is extremely important that the reduction in regulatory oversight occur only after sufficient market forces are in place to ensure that carriers do not have an ability to raise prices to inefficient levels. Therefore, the degree of regulation of a particular carrier must focus upon the degree of market power exhibited by that carrier.

*Id.* at 56.

**C. The Department Has Long Recognized That Correct "Price Signals" Are An Important Rate Objective In Itself And Important For The Competition Required To Maintain Correct Prices.**

In D.P.U. 1731, the Department adopted economic efficiency and fairness as two of the criteria for determining "just and reasonable" rates. *Id.* at 20. The Department stated:

[E]conomic efficiency means that the rate charged for a service should reflect the cost of providing the service and should provide an accurate basis for consumers' decisions about how best to fulfill their needs. . . . [E]conomic efficiency means that rates are cost-based, and reflect the cost to society of the resources consumed to produce the carrier's service. The Department has defined fairness to mean that no class of customers should pay more than the costs of serving that class.

*Id.* at 19-20.

In order to obtain these objectives, the Department in 1986 began a multi-phase investigation of Verizon's Massachusetts cost of service, rate base, required rate of return, cost allocations, marginal cost structure, rate structure and rate levels. The investigation was docketed as D.P.U. 86-33. The Department began with a review of a cost of service study ("COSS") and a marginal cost study ("MCS"). Recognizing the adverse impact on the development of competition caused by incorrect price signals, the purpose of the Department's review of this study was - as the Department later said of its D.P.U. 86-33 investigation - "to fulfill the Department's objective, as established in D.P.U. 1731, of employing appropriate regulatory tools to foreclose the possibility of improper cross-subsidization or anti-competitive pricing." D.P.U. 89-300 (June 29, 1990), at 12. The Department initially reviewed and approved a fully-distributed cost of service study methodology for Verizon. *See*, D.P.U. 86-33-C (1987). Subsequently, the Department determined Verizon's Massachusetts intrastate revenue requirement and also reviewed and approved a marginal cost study methodology for the Company. *See*, D.P.U. 86-33-G (1989). The Department thereafter opened a new docket for the purpose of investigating and determining appropriate rate levels and rate structure for Verizon. D.P.U. 89-300.

The Department's decision in D.P.U. 89-300, rendered in 1990, reaffirmed the six telecommunications public policy goals established in D.P.U. 1731: economic efficiency, fairness, simplicity, earning stability, continuity and universal service. In that order the Department approved new rates for Verizon's Massachusetts services and also initiated a transitional rate restructure process designed ultimately to move Verizon's rates to certain

"target" rates. The target rates reflected the Department's determination of the rate structure and rate levels for Verizon's Massachusetts services best designed to achieve the goals of economic efficiency and fairness. In order to avoid violation of the principle of rate continuity, the Department ordered Verizon to make annual transition tariff filings designed to achieve the target rate levels over an unspecified period of years.

Verizon made three annual transitional tariff filings pursuant to the Department's directive in D.P.U. 89-300. In its decision, issued in January of 1994, approving Verizon's third annual transition filing, the Department described its prior decisions, beginning with D.P.U. 1731, as follows:

Traditionally, the pricing of telephone service was based on a method whereby residential monthly exchange rates were priced below cost in order to promote universal service; and long distance, toll, and business rates were priced above cost in order to subsidize residential exchange rates. While this system succeeded in serving a social purpose, *it was a pricing scheme not conducive to the development of a fully competitive market, in which the benefits associated with competition would be realized by all customers. . . . With the endorsement of competition as the best way to achieve its policy goals of efficiency and fairness, it became necessary for the Department to confront the problems associated with the traditional policy of pricing services without direct regard to cost. The Department addressed the pricing issue in IntraLATA Competition [D.P.U. 1731], when it determined that "properly defined incremental costs should be used as the primary basis for pricing all services, including local exchange service," and also found that "to the extent that current rates do not reflect an appropriate allocation of costs, the Department will, consistent with the need to avoid major discontinuities in rate levels, move toward that goal."* *Id.* at 36-38.

D.P.U. 93-125 at 4-5 (emphasis added).

Moreover, in its 1994 decision, the Department reaffirmed its goal of moving Verizon's rates to the target levels. The Department stated:

In light of the increasingly competitive markets in which the Company operates, and the *imminence of competition at the local exchange level*, it is more important than ever *that steady progress toward cost-based rates be maintained*

D.P.U. 93-125 at 20 (emphasis added). In that decision the Department described its rationale for doing so in the following terms:

The Department remains fully committed to achieving *a rate structure for NET that will enable greater competition* in the telecommunications industry in Massachusetts so that the benefits of competition may accrue to the customers of NET.

D.P.U. 93-125 at pp. 9-10 (emphasis added).



In its 1995 Price Cap Order, D.P.U. 94-50 (May 12, 1995) ("*Price Cap Order*"), the Department backed away from the well established principle that Verizon's rates must be cost-based in order for efficient competition to develop. Although the Department acknowledged that "the transitional rate process, and the goals that underlie that process, have been fundamental to the Department's regulation of NYNEX since 1989," the Department believed that "discontinuing the process can be accomplished without sacrificing the policy goals underlying the rate-restructuring." *Price Cap Order* at 127. The basis for the Department's belief was that under the price cap form of regulation "the Company's rates would continue to move toward economically efficient rates, and that this goal can be achieved in a similar [time frame as that contemplated by the transition process] or otherwise reasonable time frame." *Id.* at 128. Acknowledging that "residential rates would remain below target [*i.e.*, cost-based, efficient] levels," the Department reasoned that those rates "should not be anticompetitive" because they exceed the marginal cost estimates produced by the Company's MCS. *Id.* at 129.

The Department's decision to discontinue the rate transition process was based on theory and reasonable at the time. There is, however, now experience with the Department's (at the time, theoretical) predictions that Verizon's "rates would continue to move toward economically efficient rates" (*Price Cap Order*, at 128) and that pricing residential service at the marginal cost estimates produced by the Company's MCS "should not be anticompetitive." *Id.* at 129. As discussed in more detail in Section II, below, the issue in this case is whether the Department's hoped for results of its Price Cap Order have borne out in fact, or whether a return to the Department's well grounded policies is necessary to "enable greater competition in the telecommunications industry so that the benefits of competition may accrue to the customers of NET." D.P.U. 93-125 at 9-10.

#### **D. The Department Has Long Recognized The Importance Of Price Floors For Achieving A Verizon Rate Structure That Will "Enable Greater Competition In The Telecommunications Industry."**

In D.P.U. 89-300, issued in 1990, the Department reiterated an already existing policy of setting Verizon retail prices in relation to the prices that Verizon's retail competitors paid for wholesale inputs. *See, id.* at 200-220. (At that time the only significant wholesale input was "access" for purposes of providing a competing intraLATA toll service.) In its *Price Cap Order*, the Department made it explicit that Verizon could not set retail prices less than the wholesale price that Verizon charges its competitors for "essential inputs" its competitors require to offer a competing service plus the "marginal cost of related overhead." The Department went even further in protecting competition by extending the price floor principle to services for which Verizon's competitors do not require an input from Verizon. In those cases, Verizon must set its prices at or above the marginal cost of providing the service. *Id.* at 205-206. The Department stated that "[t]his two-part price floor will prevent cross-subsidization and anticompetitive pricing." *Id.* at 206.

Issues arising from the implementation of the Department's price floor directive were taken up in *Local Competition*, D.P.U. 94-185. *See, Local Competition*, D.P.U. 94-185-B (August 29, 1996) ("*Local Competition Order*"), at 18. In the *Local Competition Order*,

the Department determined that price floors for "monopoly/essential" services for Verizon should be set at total service long-run incremental cost ("TSLRIC") and that price floors for competitive services should be set on the basis of long-run incremental cost ("LRIC"). *Local Competition Order* at 14-16. *See also*, D.P.U. 94-185-B (June 2, 1997) ("*Local Competition Order - B*"), at 1. The Department determined that an unbundled loop is an "essential element" for basic local exchange service, making basic local exchange service a monopoly service to which TSLRIC price floors apply. *Local Competition Order* at 31; [\(1\)](#) *Local Competition Order-B* at 1, n. 1. In order to implement the calculation of price floors, the Department accepted Verizon's MCS VI as a LRIC study (*Local Competition Order* at 16) and ordered Verizon to file a TSLRIC cost study. *Local Competition Order - B* at 15. The Department stated that the new TSLRIC study should include forward looking cost factors and should clearly identify assumptions made, such as the least cost, forward looking technology. *Id.* at 13. *See also*, D.P.U. 94-185-C (December 17, 1997) ("*Local Competition Order - C*"), at 2.

Verizon, however, never completed and never filed that TSLRIC study and never implemented a price floor using TSLRIC as the imputed cost of essential elements. Instead, in a pleading styled as a motion for clarification, Verizon sought relief from the TSLRIC cost study obligation and the imputation based price floor obligation that had been in effect since before 1989. Verizon argued that, since it must file wholesale tariffs for all retail services, there would no longer be a need for retail price floors based on the imputation rule (and thus no longer a need to perform a TSLRIC study). *Local Competition Order - C*, at 2-3. AT&T, among others, opposed that motion both on procedural grounds and on the ground that the offering of retail services at wholesale does not provide a price floor for facilities-based competitors or competitors relying on unbundled network elements ("UNEs"). *Id.*, at 6.

The Department, nevertheless, granted Verizon's motion. *Id.*, at 9-10. The grounds for the Department's decision were procedural. The Department found that the *Price Cap Order* had expressly left open the possibility that Verizon could satisfy its price floor obligations in this respect and - without analysis on the merits of AT&T's contention that such a price floor standard would not protect competitors other than resellers - eliminated the imputation based price floor standard. *Id.* The Department, however, expressed its concerns that, on the merits (*i.e.*, its real-world effect on competition), its decision could leave open the possibility of anticompetitive pricing by Verizon. *See, id.*, at 11 ("Today, with Bell Atlantic offering all of its retail services on a wholesale basis, the implications of the type of possible anti-competitive pricing alleged by AT&T and MCI are greater."). The Department then posed the question of whether price floors for wholesale services would solve that problem and asked for submissions from the parties, including affidavits from recognized economic experts. *Id.*

AT&T responded to the Department's *Local Competition Order - C* with both the requested submission regarding wholesale price floors (an affidavit from Dr. David Kaserman) and with a motion for reconsideration. *See, Motion Of AT&T Communications of New England, Inc. For Reconsideration Of D.P.U./D.T.E. 94-185-C*, filed on February 6, 1998. As the Department correctly noted, Dr. Kaserman stated in his affidavit that, although a "wholesale price floor can be adjusted to achieve the same ends as an imputation standard, by first determining the appropriate retail price floor and then establishing a wholesale price instead of a wholesale discount," he did not recommend such a circuitous route. D.P.U./D.T.E. 94-185-C (September 1, 1998) ("*Local Competition Order - D*"), at 4. In his affidavit, Dr. Kaserman stated that only an imputation based price floor for Verizon's retail services would be effective in protecting facilities based carriers and carriers relying on UNEs from price squeezes and other anti-competitive pricing by Verizon.

In its ruling on both AT&T's motion for reconsideration and the question of wholesale price floors in *Local Competition Order - D*, the Department continued to recognize the price squeeze concerns raised by AT&T and the failure of a wholesale discount for retail services to protect facilities based carriers. The Department, however, found that the price squeeze problem was caused by the below cost pricing of local exchange service permitted by the excessive pricing of other services (*id.*, at 7-9) - the inevitable result of the Department's earlier decision to abandon the transitional process to target rates. Rather than address the problem with price floors, the Department stated its intention to address the problem by the implementation of a competitively neutral universal service funding mechanism. *Id.*, at 9. The Department's words on this critical subject warrant repeating in full:

Current prices for Bell Atlantic's retail services do not reflect the economic (*i.e.* incremental) cost of service; nor do they generally include an efficient allocation of non-incremental costs. Pursuant to the Telecommunications Act of 1996 (see s. 252(d)(3)), wholesale prices are set at an avoided-cost discount applied to retail rates, which allows efficient competition for all retail services via resale, whether or not the retail service is priced to recover its incremental cost and an efficient share of non-incremental costs. Under these circumstances, there may be a disincentive for facilities-based competitive entry for services underpriced at the retail level. The pertinent question for purposes of this Order is whether the Department should remedy this situation by adopting a price floor requirement for wholesale services. For the reasons discussed below, the answer to that question is "no."

A price floor for wholesale services would require that the price for wholesale services be set to recover at least the economic costs (defined as incremental cost plus an efficient share of non-incremental costs) incurred in providing wholesale services. Therefore, the existing wholesale rates for underpriced retail services would violate a wholesale price floor requirement. For example, wholesale residential local exchange service in rural areas is most likely priced below the economic cost of building network facilities to service residential customers in rural areas. A wholesale price floor requirement thus would require that retail rates be increased to a point where the avoided cost discount would be greater than the economic cost of providing the service. The Department in the early 1990s undertook a significant rate-rebalancing initiative for Bell Atlantic (then New England Telephone) which, among other things, raised prices significantly for some underpriced services significantly over a four-year period. We are not prepared to further rebalance rates at this time in order to accommodate a wholesale price floor. The disincentive for facilities investment can be mitigated by a competitively-neutral universal service funding mechanism, which would provide support to carriers equal to the difference between the universal service price and the forward-looking cost of providing the services in question. The Department intends to investigate this and other universal service policies in a forthcoming docket.

*Id.*, at 7-9 (footnotes omitted).

## **II. IN THIS PROCEEDING, THE DEPARTMENT MUST ADOPT A REGULATORY MODEL THAT ENSURES VERIZON'S RETAIL PRICING STRUCTURE AND PRICING FLEXIBILITY "ENABLE GREATER COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY," RATHER THAN IMPEDE OR PREVENT IT.**

The essential problem that the Department faced in 1989 when it opened D.P.U. 89-300 was stated best in the third of the transitional rate filings mandated by D.P.U. 89-300: how to establish and maintain "a rate structure for [Verizon] that will enable greater competition in the telecommunications industry in Massachusetts so that the benefits of competition may accrue to the customers of [Verizon]. D.P.U. 93-125, at 9-10. It is a problem that the Department still faces today. This proceeding should build on the lessons of the past; it should develop a record on the experience gained from the implementation of its policies regarding Verizon's rate structure and pricing flexibility and construct its policy going forward on the basis of that experience.

### **A. As A Preliminary Matter The Department Must Investigate The Extent Of Competition In Each Market In Which Verizon Seeks Pricing Flexibility And Whether It Is Sufficient To Ensure "Just And Reasonable" Rates.**

#### **1. The Department Should Investigate The Legal Requirements For "Just And Reasonable" Rates.**

Competition is not a goal in itself; it is a means to an end. If competition is to be relied on by the Department, it must be sufficient to produce "just and reasonable rates," because it is the Department's statutory responsibility to ensure just and reasonable rates. Mass. G.L. c. 159, § 14 states in relevant part:

Whenever the department shall be of the opinion . . . that any of the rates, fares or charges of any common carrier for any services to be performed within the commonwealth . . . are unjust, unreasonable, unjustly discriminatory, unduly preferential, in any wise in violation of any provision of law, or insufficient to yield reasonable compensation for the service rendered, the department shall determine the just and reasonable rates, fares and charges to be charged for the service to be performed, and shall fix the same[.] . . . Every such common carrier shall obey every requirement of every such order served upon it, and do everything necessary or proper in order to secure absolute compliance with every such order by all of its officers, agents and employees.

*See also*, Mass. G.L. c. 159, § 17 ("every unjust or unreasonable charge is hereby prohibited and declared unlawful").

Although the statute says little as to what constitutes "just and reasonable" rates, it does provide some guidance. It does, for example, require just and reasonable rates for each service that Verizon performs, not simply just and reasonable rate levels overall in comparison with Verizon's overall costs. *See*, G.L. c. 159, § 14 ("for any service to be performed"; "for the service rendered"; "for the service to be performed"). Moreover, it also makes clear that the provision of service *below cost* violates the prohibition against unjust and unreasonable rates. *Id.* ("insufficient to yield reasonable compensation for the service rendered"). Furthermore, the repeated prohibitions against undue discrimination and preferential treatment make it clear that just and reasonable rates must meet certain rate design criteria.

In order for the Department to determine the appropriate pricing and price regulation for Verizon, the Department must have developed the appropriate criteria for what constitutes "just and reasonable" rates. The scope of this proceeding should not exclude such a fundamental issue.

#### **2. The Department Should Investigate The Extent To Which There Is Sufficient Competition To Ensure That Verizon's Retail Rates Remain Just And Reasonable Rates.**

As discussed above, the Department, in D.P.U. 1731, established criteria for deciding when, and in what circumstances, it would be appropriate to reduce its traditional regulatory oversight of Verizon's services and pricing. The Department stated, "The degree of regulation that should apply to a particular market should

reflect the degree of competition present." *Id.* at 45. The Department went on to say that "the degree of regulation of a particular carrier must focus upon the degree of market power exhibited by that carrier." *Id.* at 56.

Because the degree of market power that Verizon possesses may vary depending upon the market, there is no substitute for a market by market analysis of the extent to which there is sufficient competition to ensure that Verizon does not have the ability to raise (or lower) its prices above (or below) just and reasonable rates. Such an inquiry is necessarily different from the one that the Department conducted in D.T.E. 99-271. In that proceeding, the Department focused on the specific actions that Verizon was required to perform for competitors for each of the specific checklist items. A conclusion that Verizon satisfies each of the specific checklist items does not mean that Verizon faces sufficient competition in *each* market in which it operates to ensure that the rates for *each service* in each market will be just and reasonable.

Indeed, the New York Public Service Commission ("NYPSC"), in a currently pending proceeding comparable to this one, on how to regulate Verizon, expressly found that the status of competition and the effect of any proposed method of Verizon regulation on competition were important parts of its investigation. *Proceeding on Motion of the Commission to Consider Cost Recovery by Verizon and to Investigate the Future Regulatory Framework*, Case 00-C-1945, *Ruling On Scope and Schedule*, issued February 27, 2001 ("*NY Scope Ruling*"), at 4. The NYPSC staff was already in the process of conducting its "own investigation concerning the state of competition and, in particular, the health of facilities-based competition." *NY Scope Ruling*, at 4, n. 3. The NYPSC, therefore, anticipated "having the benefit of the outcome of this investigation in time to take it into consideration." *Id.* Finally, the NYPSC made clear that a market by market assessment of the state of competition would be an important part of its assessment of the proper method for regulating Verizon going forward:

Ruling on these proposals will require an assessment of Verizon's operations as both a wholesale provider and a retail local exchange company and of the *state of competition in the market in which they are conducted*.

*Id.*, at 4.

The starting point of the Department's investigation into whether competition is sufficient to discipline Verizon's prices can start with Verizon's own proposal. On its face, Verizon's proposal is inconsistent with the proposition that there is sufficient competition to restrain Verizon's pricing. A proposal to reduce access rates, but only on the condition that Verizon is permitted to increase residential dial tone rates, is hardly the action of a company worried about being under priced by its competitors, in either the access market or in the local residential market. Moreover, Verizon's request for a right to increase rates on account of "exogenous costs" indicates that it is the Department, not competitors, which restrains Verizon's power to increase rates.

Back in 1985, in D.P.U. 1731, the Department established the important regulatory principle that the degree of competition should determine the extent to which price regulation may be relaxed. Implementation of this principle necessarily requires an investigation into the extent of competition in each market before Verizon's price cap regulations can be relaxed. The NYPSC has followed the Department's advice and proceeded with such an investigation. The Department should follow its own advice and do the same.

#### **B. The Department Must Investigate Verizon's Costs And Earnings To Ensure That Verizon's Overall Rate Level Is Just And Reasonable.**

It is axiomatic that the Department cannot have any assurance that Verizon's rates going forward will be just and reasonable without an understanding of whether they are currently producing excess profits and whether some services are cross subsidizing others. The NYPSC was unequivocal about the need for information regarding Verizon's revenues and costs in a proceeding to determine the proper regulatory structure going forward. It stated:

Verizon should make the initial filing, a filing that must encompass both an analysis of Verizon's earnings and financial condition and its proposed regulatory plan. The financial information is needed because consideration of any regulatory plan for Verizon must include a review of its financial condition in order to ensure that rates are just and reasonable.

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The financial information included in Verizon's initial submission should encompass at least a forecast of regulated earnings during the seventh year of the [current "performance regulatory plan" ("PRP")], tied to a consideration of a base period comprising the fifth year of the PRP, and further earnings forecasts adequate to support any proposed regulatory plan.

*NY Scope Ruling*, at 4-5.

Moreover, a collateral benefit of conducting a careful analysis of Verizon's costs and revenues will be additional information regarding the degree of competition in Verizon's markets. Clearly, if Verizon is earning excess profits, that is a good indicator that there is not yet sufficient competition to restrain Verizon's power to extract monopoly rents in above cost pricing. (It should be noted, however, that the absence of monopoly profits overall does not necessarily mean that Verizon is adequately constrained by competition. This is because Verizon could be using excess profits in one area to cross subsidize and preclude competition in another area.)

**C. The Department Should Investigate Verizon's Rate Design And Rate Structure To Ensure That The Rates For Each Service Are Consistent With The Development Of Competition And Are, Thus, Just And Reasonable.**

The implementation and maintenance of a Verizon rate design that permits the development of competition is the heart of this case. If Verizon is permitted to price certain services below cost because they are cross subsidized by excessive prices on other services, competition will never develop in Massachusetts for the services priced below cost. As noted above, the Department has already recognized the problems created by Verizon's existing price structure: "[T]here may be a disincentive for facilities-based competitive entry for services under priced at the retail level." *Local Competition Order - D*, at 8. It is essentially the same problem that the Department faces in the electric industry, where the incumbent's "standard offer" under-prices the market and excludes competitors by subsidizing basic service from other revenue sources.

In the electric industry, however, the Department has faced the problem head-on. In its last two restructuring cases (for Western Massachusetts Electric Company and for Fitchburg Gas and Electric Company), the Department eliminated the perverse price signals caused by pricing retail services less than wholesale services. *In Western Massachusetts Electric Company*, D.T.E. 97-120 (September 17, 1999), at 190, the Department stated:

As noted above, the Department's policies regarding standard offer pricing were recently expressed in D.T.E. 97-115, at 26-31, in which the Department indicated that, ideally, "the price for standard offer generation would be set to recover its costs." In addition, the Department noted that, "based on our observations of market activity in Massachusetts and other jurisdictions during the past year, the Department now believes that the transition to a competitive market may be slowed unnecessarily by the divergence of retail and wholesale prices." . . . Because WMECo's proposed retail prices are significantly below estimated wholesale prices, the proposed retail prices would not provide for an expedient and orderly transition to a competitive generation market.

The Department should do the same in this case for the telecommunications industry.

It is time now for the Department to undertake the rate design issues it declined to do under the price cap plan. As discussed above, the Department had hoped that Verizon's "rates would continue to move toward economically efficient rates" (*Price Cap Order*, at 128) and that pricing residential service at the marginal cost estimates produced by the Company's MCS "should not be anticompetitive." *Id.* at 129. This case should include an investigation as to whether rates have moved to economically efficient levels and whether pricing Verizon's residential service at the marginal cost estimates produced by the Company's MCS is anticompetitive. If the Department finds, as AT&T believes it will, that Verizon's rate design is economically inefficient and its residential rates are anticompetitive, then this case should include a determination of the appropriate rate structure.

**D. The Department Should Ensure That Verizon's Rate Structure Remains Economically Efficient Over The Term Of The Plan By Establishing An Imputation Based Price Floor And By Establishing A Transparent Universal Service Subsidy To Address Universal Service Issues.**

**1. For Both Procedural And Substantive Reasons, Now Is The Time For The Department To Establish Proper Price Floors And A Universal Service Funding Mechanism To Mitigate Any Potentially Adverse Effects.**

In *Local Competition Order - C* and *Local Competition Order - D*, the Department declined to adopt an imputation based price floor. The Department acknowledged that the failure to adopt an imputation based price floor could permit price squeezes that would discourage facilities based entry. *Local Competition Order - C*, at 11; *Local Competition Order - D*, at 8-9. As discussed above, the Department based its decision on procedural grounds, finding that the Price Cap Order permitted it to use resale as a substitute for price floors. *Local Competition Order - C*, at 11. The Department had substantive reasons as well, which it made clear in *Local Competition Order - D*. Because residential retail service is currently priced below cost, a price floor based on imputing cost-based charges for wholesale inputs would require residential rates to be increased. *Id.*, at 8-9. The Department noted its early 1990s rate-rebalancing and stated that it was "not prepared to further rebalance rates at this time in order to accommodate a wholesale price floor." *Id.*, at 8-9. The Department did, however, offer a possible solution to the problem, "a competitively-neutral universal service funding mechanism." *Id.*, at 9. The Department then stated, "The Department intends to investigate this and other universal service policies in a forthcoming docket." *Id.*

It is time now for the Department to establish a proper price floor. With regard to the procedural aspect of the Department's prior declination to approve a proper price floor, Verizon will no longer be operating pursuant to the *Price Cap Order* in which the Department had suggested that the offering of retail services at

wholesale could satisfy a price floor requirement. With regard to the more substantive issue, the Department should undertake the investigation into a competitively-neutral universal service funding mechanism that was promised in *Local Competition Order - D*.

As the Department correctly recognized, a competitively neutral universal service funding mechanism could mitigate any adverse universal service consequences of adopting the economically efficient rate structure for Verizon that a proper price floor would necessitate. At the same time, it would not undermine the beneficial effects of an economically efficient rate structure on the development of facilities based competition. Implementing such a plan would require the explicit identification of the amount and the source of the cross subsidy that Verizon provides for universal service purposes. Such amounts could then, for example, be removed from the source retail rates (*e.g.*, access rates) and the residential rates adjusted upward commensurately. Under this illustrative example, Verizon (and all other carriers) could be required to pay into a universal service fund. All carriers could seek to recover such costs from *competitive retail* services where the market would permit. The monies in the universal service fund could then be available *to every carrier* that provides residential retail service in proportion to its number of residential customers. In other words, there is an explicit, visible subsidy that moves with the customer when the customer moves to the carrier of her choice.

The foregoing suggestion is not intended to be a definitive proposal. It is, in fact, what the Department was essentially describing as its intent in *Local Competition Order - D*. The Department should in this docket undertake an investigation which will lead to a result that is consistent both with universal service principles and with principles of economically efficient rate design that will permit the development of competition.

## **2. The Department Can Rely On The Cost Studies That Will Eventually Be Approved In The UNE Cost Docket, D.T.E. 01-20 To Develop A Price Floor.**

In its *Local Competition Order*, the Department had "found that TSLRIC was the appropriate methodology to use to determine prices for NYNEX's monopoly/essential services, for computing price floors for monopoly services, and for measuring subsidies, and that LRIC was the appropriate methodology to use to determine prices and price floors for non-essential services." *Local Competition Order - A*, at 9, citing *Local Competition Order* at 15-16. Furthermore, the Department determined that access service and the loop are included in the essential inputs for which TSLRIC must be calculated. *Local Competition Order*, at 31. The Department directed Verizon to develop and file a comprehensive description of the method it proposed to use to complete its TSLRIC study within 60 days of the date of the *Local Competition Order*, and within 60 days of the approval by the Department of that method, to submit a geographic-based TSLRIC study for monopoly and essential network elements, in accordance with the approved TSLRIC methodology. *Local Competition Order*, at 17. *See also*, *Local Competition Order - A*, at 9. As discussed above, however, Verizon never prepared or submitted such a study.

In order to implement a properly calculated price floor, it will no longer be necessary to prepare a TSLRIC cost study. The Department may now rely on the TELRIC cost estimates that will eventually be approved in D.T.E. 01-20. Indeed, because the TELRIC methodology will determine the price of the "monopoly/essential" inputs that Verizon will charge its competitors to offer a competing service, it is the proper basis for calculating an imputation based price floor.

## **E. The Department Should Include Access Pricing In Its Investigation Of Verizon's Rate Structure.**

Verizon's access prices have historically provided a substantial amount of "contribution" (the amount by which revenues exceed incremental cost of the service). Such "contribution" has been available to Verizon to use as it sees fit; it may be used to recover joint and common costs, to subsidize residential local exchange service, to subsidize other potentially competitive services, or some combination of these uses. Under the rate rebalancing that the Department should conduct in this proceeding, access should be priced at its long run incremental cost with a reasonable factor for the proportionate collection of joint and common costs. It should not be priced so as to generate excess funds that Verizon may use to subsidize other services. With the implementation of an explicit and visible universal service subsidy, there will be no need for Verizon to over price its access service.

Given the clarity of the case for access rate reduction and the fact that Verizon itself has proposed a limited reduction, AT&T suggests placing the issue of access rates on a separate track so that this issue can be addressed expeditiously. AT&T suggests that, at a minimum, the Department approve Verizon's a proposed access rate reduction on an interim basis and continue to investigate further reductions necessary to bring access rates down to the long run incremental cost of access.

## **Conclusion**

The regulatory plan that the Department puts in place in this docket is likely to last for several years. If the Department does not create a rate structure for Verizon that permits the development of facilities-based competition and a price floor requirement that will maintain that rate structure, there will be little likelihood of local exchange competition developing during the term of the plan. Indeed, there may be no competitors left at the end of the plan. The Department should complete in this docket the revolution in intraLATA telecommunications regulation it began with its pioneering decision in D.P.U. 1731.

Respectfully submitted,

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1. 1 Consistent with the terminology at the time, in its *Local Competition Order*, the Department referred to an unbundled loop as a "link."